In the Supreme Court
OF THE
United States

OCTOBER TERM, 1941

No.

J. R. MCDONALD, J. R. MASON and MARY E. MORRIS,
Petitioners,

vs.

BANTA CARBONA IRRIGATION DISTRICT,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Ninth Circuit appears in the record at R. 386. It is reported. See 123 Fed. (2d) 968. The *Merced District* case referred to in the decision appears in 114 Fed. (2d) 654.

No opinion was rendered by the District Court.

(NOTE): All italics throughout the brief are ours.

II.

STATEMENT OF THE CASE.

We have in the petition given an outline of the case with references and we have shown the points involved. Additional references will be made under the points argued.

III.

SPECIFICATIONS OF ERRORS.

As required by the rules of the Ninth Circuit statements of the points relied on were filed. These are set out on pages 364 to 371 of the record and they constitute errors that were relied on on the appeal.

They are mentioned and explained at pages 2 to 3 of the preceding petition and they are comprised in the points next set out.

IV.

THE RECONSTRUCTION FINANCE CORPORATION WAS NOT QUALIFIED TO GIVE THE TWO-THIRDS CONSENT TO THE IRRIGATION DISTRICT'S PLAN OF COMPOSITION, BECAUSE IT WAS AN INTEGRAL PART OF THE PLAN THAT IT SHOULD RECEIVE TAX FREE 4 PER CENT BONDS OF THE DISTRICT FOR THE INTEREST IN THE BONDS WHICH IT HELD AND WHICH IT VOTED AND THE PETITIONERS, DISSENTING BONDHOLDERS, WERE COMPELLED TO RECEIVE A CASH PAYMENT FOR THEIR BONDS AND TO TURN THEIR BONDS OVER TO THE R.F.C. AND PERMIT IT TO RECEIVE BONDS EVEN FOR THOSE BONDS. THE PLAN WAS NOT FAIR. IT DISCRIMINATES.

As already shown reliance is placed on the *City of Avon Park* case and Section 83 of the Bankruptcy Act,

and we point to an additional Circuit Court of Appeals ruling.

While it might be argued that the point here made was ruled upon by implication adversely to the bondholders in the cases referred to in the opinion of the Circuit Court of Appeals, because certiorari was denied in those cases, that is no excuse for the error and the making of one rule in this case and another in the *City of Avon Park* case. And we respectfully contend that if full effect is to be given to the *City of Avon Park* case this Court should declare that neither in an irrigation district or municipal bankruptcy case is it permissible to treat one creditor different from another in enforcing a plan of composition. In the *Merced* case the Circuit Court of Appeals said:

> "The obligation assumed by the R.F.C. was subject to the condition that all old securities should be purchased and held by R.F.C. until R.F.C. was satisfied the refinancing was complete. During this time the old securities were to be kept alive and outstanding. When the refinancing was complete, then and then only was the R.F.C. under the duty of buying and accepting refunding bonds and surrendering old securities for cancellation."
>
> *West Coast Life Ins. Co. v. Merced Irr. Dist.*, 114 Fed. (2d) 654, 677.

It would seem clear that the statement is (a) not founded on fact and (b) that it disregards the legal situation which arose, the instant the R.F.C. elected to enter the Bankruptcy Court and agree in writing

to a plan affecting the bonds it held. When the R.F.C. elected as to bankruptcy and became a creditor entitled to file its claim, any contract that said it *must* for its claim have bonds ceased to be effective. All the bonds became subject to the rule of fairness and to a uniform nondiscriminatory plan. The District had no right to get petitioners' bonds for cash and for conversion into bonds for the benefit of the R.F.C. We were entitled to the new tax free 4 per cent bonds if the R.F.C. was so entitled. It is nice in these times to get as an entirety the whole issue of these bonds representing a reduction of a rich District's debt—by more than half when principal and interest is counted—but where is the sanction in law for what occurred here? Who paid a true price for the bonds of this District? These bonds are tax free and they are perfectly secured.

First let us state that the original loan resolution of May 28, 1938 specifically provided that the R.F.C. was not to advance a penny to any bondholder who said he was willing to subject his bonds to the rights accorded to the R.F.C. *and that such was the loan contract that was voted by the District and to have a loan at all from the R.F.C. required a vote of the District.* (The point was not clearly dealt with in the *Merced* case or in the other cases; nor was the *City of Avon Park* case considered at all in those cases.) The provision of the loan resolution of May 20, 1938 was that the loan of $702,500.00 should be scaled if bondholders Tom, Dick or Harry said they would take what the R.F.C. was to get. It was never agreed the

R.F.C. must have all the new bond issue. We quote from the original R.F.C. loan resolution:

> "(f) When any of the Old Securities are not deposited as herein provided but such Old Securities *are nevertheless subjected to the refinancing plan herein contemplated and the obligation of the Borrower evidenced by such non-deposited securities is thereby reduced in the same ratio and to the same extent as would have been the case if such non-deposited securities had been deposited, this Corporation shall be under no obligation to make any disbursements for the purpose of taking up or refinancing any of such non-deposited securities,* but if they have been so subjected to the refinancing plan within such time as may be fixed or approved by the Division Chief prior to the date fixed in paragraph 1 of the Resolution, or such extended date as may be fixed by this Corporation as therein provided, they shall be added to the amount of Old Securities deposited for the purpose of determining the percentage of deposited Old Securities upon which disbursement shall be made." (R. 254.)

How in the name of common sense could the obligation of the borrower be merely reduced except by refunding?

Language could not be clearer. If holders of 80% of the old securities said: We agree to the plan of refinancing, there was not so much as a shadow of a provision in the resolution from beginning to end that said the R.F.C. must have all the new bonds or nothing. It was not to pay out a penny on the 80%.

The election to vote on acceptance of that resolution was held on October 19, 1938. (R. 309.)

And the proposition voted on was whether the R.F.C. resolution of May 20, 1938 should be accepted. (R. 311.)

Now California law required that election as a condition of accepting the loan from the R.F.C. Section 11 was added in 1933 to the State Borrowing Act of 1917. Said new section permitted contracting with the R.F.C. to refund a District's debts. *It was always the law that a District could refund its bonds through agreement between itself and its bondholders.* The new section with respect to a loan from the R.F.C. read:

> "As evidence of such loan or loans and the obligations of such district to repay the same to the United States or any agency thereof, any irrigation district, upon being authorized so to do as provided by section 3 of this act as hereinafter in this section modified, may make and enter into contract or contracts with the United States or any agency thereof, as a condition or requirement to the making of such loan or loans."
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> Cal. Stats. 1933, p. 2395.

Section 3 of the said Act of 1917, referred to in new Section 11, required that any contract made with the R.F.C. to provide funds for works must be approved by an election.

Cal. Stats. 1917, p. 243.

The written contract of *October 31, 1938* (after the election of October 19, 1938) to sell the 4 per cent

bonds to the R.F.C. did not say that the R.F.C. must receive all the issue or nothing. Certainly no such contract was ever voted. The contract states:

> "3. Amounts of Bonds to Be Purchased: R.F.C. shall be *under no obligation to purchase refunding bonds beyond the amount necessary, in its judgment for refunding* the indebtedness owed to creditors of the Borrower who join in the plan of refinancing, contemplated in a resolution of R.F.C. authorizing this loan and adopted May 20, 1938. *In the event any of the refunding bonds are sold to purchasers other than R.F.C., the principal amount of bonds which R.F.C. is obligated to purchase, shall be correspondingly reduced.*" (R. 285, 286.)

So petitioners are to be penalized for contesting.

We are concerned with a bankruptcy act of Congress. Any attempt by contract to weave into the remedy of Section 83 something that is not permitted is invalid. If the *Merced* case means the contrary, it is plain error. Its language might be appropriate in a specific performance case, but the truth is the statement made in the case as to what the contract was is unwarranted. Nor could the contract claimed be binding in bankruptcy.

The *City of Avon Park* case means that when this petition was filed the R.F.C. was not qualified to coerce the dissenting bondholders into this plan if it had rights which would make it more willing to give its consent. It is obvious that it did have such rights if it could call for bonds and the dissenting bondholders could not. It was no more impartial than was

the assenting creditor in the *City of Avon Park* case or the assenting landowner who held bonds of the District in the following case, in which an improvement district's bonded debt was to be reduced by the plan of composition.

Kauffman County Levee Imp. Dist. No. 4 v. Mitchell, 116 Fed. (2d) 959.

In the *City of Avon Park* case R. E. Crummer & Co., called Crummer, acting as fiscal agent of a city, solicited the two-thirds consent to a plan. The plan revealed that Crummer was to have from bondholders a minimum fee of $20.00 a bond and that if the fee was the minimum he might receive more for the coupons of the bonds than was to be paid the depositor. The flat fee was $40.00 per bond if there was no contingent compensation. But Crummer had bought up bonds and he proceeded to buy up bonds at distress prices and he did not disclose his prospective profit on these bonds to those solicited to deposit. Crummer's consent was necessary to a two-thirds consent. The Court held the plan was not fair and that it was not accepted in good faith. It treated Crummer's hidden advantage as virtually a part of the entire transaction. On fairness the Court said:

> "Beyond that is the question of unfair discrimination to which we have adverted. Compositions under chap. IX, like compositions under the old sec. 12, envisage equality of treatment of creditors. Under that section and its antecedents, a composition would not be confirmed where one creditor was obtaining some special favor or inducement not accorded the others, whether that con-

sideration moved from the debtor or from another. Re Sawyer (DC) 2 Low. Dec. 475, Fed. Cas. No. 12,395; Re Weintrob (DC) 240 F. 532, 39 Am. Bankr. Rep. 407; Re M. & M. Gordon (DC) 245 F. 905, 40 Am. Bankr. Rep. 301. As stated by Judge Lowell in Re Sawyer, supra, 'If a vote is influenced by the expectation of advantage, though without any positive promise, it cannot be considered an honest and unbiased vote.' That rule of compositions is but part of the general rule of 'equality between creditors' (Clarke v. Rogers, 228 U. S. 534, 548, 57 L. ed. 953, 959, 33 S. Ct. 587, 30 Am. Bankr. Rep. 39) applicable in all bankruptcy proceedings. That principle has been imbedded by Congress in chap. IX by the express provision against unfair discrimination. That principle as applied to this case necessitates a reversal. In absence of a finding that the aggregate emoluments receivable by the Crummer interests were reasonable, measured by the services rendered, it cannot be said that the consideration accruing to them, under or as a consequence of the adoption of the plan, likewise accrued to all other creditors of the same class."

American United Mut. L. Ins. Co. v. Avon Park, 311 U. S. 138, 147, 148, 85 L. ed. 91, 96.

The Court stated that a Bankruptcy Court was a Court of Equity, that it ignored any subtle arrangement that involved unfairness. We stand here on the simple proposition that the whole profit the R.F.C. was entitled to make out of its bargain was the 4% interest which it received on its advances. It was paid its interest up to January 1, 1939. (R. 160.)

It presented its bills on a semi-annual basis and it had sent in its bill for the period from January 1, 1939 to July 1, 1939 when the case was tried. This second bill was for $12,583.48. (R. 361 to 363.)

What it could get beyond that was subject to Section 83.

All that we are arguing for is this: That this Court shall make this great corporation stand by what it elected to become when it consented to this plan and forced our clients to sacrifice their bonds at a hideous discount. For six years the District paid nothing and then was given the 61% settlement.

There must be kept out of this case any theory that because the plan contemplated "4 per cent bonds", the R.F.C.'s rights were different. This feature of similarity did not give the R.F.C. the right to all the bonds. The plan might have provided for a 7 per cent issue. The plan had to stand the test of Section 83.

Not only does Section 83 of the Bankruptcy Act prohibit discrimination but California law has, ever since 1917, placed all bonds of an Irrigation District on the same plane and it is the final ruling of the Courts in California that in case a District becomes unable to pay its bonded indebtedness all of its indebtedness must be treated as matured as in bankruptcy and its assets must be shared pro rata. This was definitely ruled in the following case:

Clough v. Baber, 38 Cal. App. (2d) 50, 100 Pac. (2d) 519. (Hearing denied by Supreme Court.)

The theory of the *Bekins* case was that Section 83 was valid because it did not interfere with state law at all. (*U. S. v. Bekins,* 304 U. S. 27, 82 L. ed. 1137.)

When Section 80 of the Bankruptcy Act was invalidated in the *Cameron County Improvement District* case California passed a state bankruptcy act which said a District could present a plan of composition to a state Superior Court and if the Court found the plan fair and equitable and the bondholder refused to accept it, the District could condemn his bonds at market value. All creditors were made parties.

Cal. Stats. 1937, p. 1876.

Counsel for this Irrigation District represented South San Joaquin Irrigation District. They proceeded for such District to present a plan consented to in writing by the R.F.C. under a loan resolution which contained the words of the one before the Court. That resolution was for the purposes of state law treated as putting in the R.F.C. such title to the bonds taken up as enabled it to give the required two-thirds consent. Admitting that under that resolution and under that law the plan to be fair must allow the dissenting bondholder the new bonds if the R.F.C. was to get bonds under the plan for those it had taken up in the precise manner involved in this case, the state Court petition read:

> "Petitioner further proposes, in its plan of readjustment of its outstanding bonded indebtedness, to issue to all holders of outstanding bonds of petitioner who have not deposited, or made available, their said bonds for retirement and

> liquidation for the cash offer hereinabove proposed, new bonds in the principal sum of $684.69, for each $1000.00 outstanding bond, bearing interest at the rate of four (4) per cent per annum, which said new bonds shall be identical in respective principal amount, interest rate, maturities, and in all other respects as the bonds that are to be issued to the United States Government, through the Reconstruction Finance Corporation, by petitioner under the terms of the loan hereinabove referred to granted by the Reconstruction Finance Corporation to petitioner."

Such counsel appeared as attorneys for the R.F.C. in the case. It is now claimed that this was a species of inadvertence. If it represented no mental process, accident strangely conformed to fairness. It occurred in a three million dollar case. We ask not to travel outside this case, but that it is not fiction when we say the R.F.C. not only wants the 4% on its "loan" but profit out of the other handle of the deal—its right to consider its status that of the holder of the old bonds, one may note page 4 of the publication of proceedings of California Irrigation District Association where it is said:

> "All the irrigation district bonds held by the R.F.C. carry 4% interest and bond houses are buying them. During the past few months, the R.F.C. has sold all of Merced, Pescadero, Alpaugh, Corcoran, Citrus Heights and LaMesa, Lemon Grove & Spring Valley districts' 4% bonds, amounting to $10,871,768.00 *and all of them at a substantial premium,* and there are bond houses now seeking to purchase others."

By the bond purchase contract, those bonds conform to Sections 3 to 9 of the California Districts Securities Commission Act, so that they could be certified as legal investment for savings banks and trusts, the best security in the world. (R. bottom of page 388.)

Those sections required (Cal. Stats. 1931, pages 2264 to 2266) that in the security behind the bonds there should be an equity of 40% and the valuation was a depression valuation. We quote from Section 4:

> "No bond issue of any district shall be approved by certification as provided in this act which together with any other outstanding bonds of such district including bonds authorized but not sold exceeds sixty per centum of the aggregate value of the water, water rights, canals, reservoirs, reservoir sites, irrigation and power works and other property owned by the district or to be acquired or constructed with the proceeds of the bonds proposed to be issued by said district, and the reasonable value of the lands within the boundary of the district."
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> Cal. Stats. 1931, p. 2265.

That entire equity, the old bondholders were compelled to unconditionally waive. It is not equality or justice to fatten the purse of the R.F.C. out of the misfortune of these private lenders who are losing over half their claims. When the great R.F.C. says: I must have bonds—all the bonds, it and not the dissenting bondholders plays the Shylock. The Court says: The vast number of your bonds does not make

you superior to the law. And when one looks back and says that by private contract many old bondholders sold for cash and others should not get more, unreasonable indeed is a ruling which concedes the vitality of the old bonds was not destroyed but were still "owned" and which requires that a dissenting bondholder must take something less for his bonds as a penalty for having insisted on a hearing, while another right is accorded to those bonds so still "owned" by the R.F.C.

Dated, Berkeley, California,
February 27, 1942.

Respectfully submitted,
J. R. McDONALD,
J. R. MASON,
MARY E. MORRIS,
Petitioners.

By W. COBURN COOK,
Attorney for Petitioners.

GEORGE CLARK,
Of Counsel.

Due service and receipt of a copy of the within is hereby admitted

this _____ day of February, 1942.

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Attorneys for Respondent.